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INTEREST-FREE LOANS TO FAMILY MEMBERS: A NEW DANCE STEP

by

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I. INTRODUCTION

INTEREST-FREE loans to related individuals may offer new hope in man's eternal quest to avoid the onerous taxes imposed by all forms of government. The elaborate dance ritual in which tax collector and taxpayer engage often resembles the native Caribbean dance of "limbo," with the tax collector continually striving to lower the pole and the taxpayer struggling to devise ingenious new contortions that will allow him to slip under it. The tax attorney's role in this scenario is to determine for taxpayer just "how low you can go."[1]

Thanks to the Tax Court's recent decision in *Crown v. Commissioner*,[2] which is a reaffirmation of the earlier district court decision in *Johnson v. United States*,[3] this limbo contest may have just commenced. Under the gift and estate tax rules in effect prior to 1977, an estate plan might have called for inter-vivos transfers designed to take advantage of the lower gift tax rates and the dual taxing mechanism whereby inter-vivos transfers and testamentary transfers were subject

[1]"Low" is in no way intended to suggest deviousness or illegality; I merely draw the analogy between a quaint native dance and the taxpayer's quaint game of tax avoidance, both of which are perfectly legal. *See* 240 U.S. at 630-31, *infra* note 8.

[2]67 T.C. 1060 (1977). [*Editor's note:* While this article was being edited, the Court of Appeals for the Seventh Circuit affirmed the Tax Court's decision in Crown v. Commissioner, 585 F.2d 234 (7th Cir. 1978). The Internal Revenue Service announced its nonacquiescence in the decision. 1978-22 I.R.B. 6.]

[3]254 F. Supp. 73 (N.D. Tex. 1966).

to two different and separate sets of rates. The objective of the new limbo contest will be avoidance of the 1976 Tax Reform Act's unitax rate structure, which causes gifts and testamentary transfers to be similarly taxed, assuming the same value of the transferred property.[4] Besides possibly postponing the grasp of the unitax,[5] the real objective of the dance may be avoiding the income tax ramifications, which are just as important to a taxpayer (although it should be noted that income tax law has no operative effect on gift tax law).[6] There are, in reality, two areas of taxation being dealt with under this topic—gift tax and income tax.[7]

II. THE TERMINOLOGY CONFRONTED

A. *What is Tax Avoidance?*

Tax evasion amounts to an escape from tax by illegal means; tax avoidance is an escape from tax by legal means, namely by a reduction of the taxable income. The distinction was drawn by Justice Holmes:

> We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the *full* of what the law permits. When the act is condemned as an evasion, what is meant is that it is on the wrong side of the line indicated by the policy if not by the mere letter of the law.[8] (Emphasis added).

If the operation of tax laws is merely burdensome on the taxpayer, the courts will afford no relief.[9] On the other hand, taxing statutes may not be extended beyond the clear import of the language used.[10] The principle has often been stated that a taxpayer has a right to decrease his taxes by reduction of his tax base if the transaction is real.[11]

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[4]I.R.C. § 2001.

[5]Guy B. Maxfield, *Tax Reform Act Special Supplement*, FEDERAL ESTATE AND GIFT TAXATION 5 (Stephens, Maxfield & Lind, 1965). In addition, the 1976 Tax Reform Act changed I.R.C. § 2035 to provide that gifts made within three years of the date of death are automatically included in the decedent's gross estate without a contemplation assumption. Section 2035(c) further provides that the inter-vivos transfer tax paid will be included in the gross estate under what is known as the "gross up" process.

[6]*See* United States v. Davis, 370 U.S. 65 (1962).

[7]This article will be limited in scope to treating only interest-free loans among related individuals.

[8]Bullen v. Wisconsin, 240 U.S. 625, 630-31 (1916).

[9]Burnet v. Standford & Brooks Co., 282 U.S. 365 (1931).

[10]*McFeely v. Commissioner*, 296 U.S. 102 (1935).

[11]R. B. Cowden, 9 T.C.M. 1148 (1950). *See* Griffiths v. Helvering, 308 U.S. 355 (1939) (authority for the principle that the particular transaction involved must be a natural business transaction, and not "hocus-pocus").

B. *What is Property?*

To start with a jurisprudential view, Roscoe Pound claimed:

> In civilized society men must be able to assume that they may control, for purposes beneficial to themselves, what they have discovered and appropriated to their own use, what they have created by their own labor and what they have acquired under existing social and economic order.[12]

Even though this may be a jural postulate of civilized society as we know it, there are as many views as there are sections in the Internal Revenue Code. The United States Supreme Court has gone so far as to hold that a person's interest in governmental benefits is a "property interest" and subject to procedural due process if the claim of "entitlement" to the benefit is supported by the rules of the agency affording the benefit.[13] The Court, in a more recent case,[14] established that "protected interests" in property are not ordinarily created by the United States Constitution itself; but rather, the entitlements are created, and their dimensions defined, by an independent source such as a state's common law, statutes, or rules entitling an individual to certain benefits.[15]

The better definition of "property" vis-a-vis non-interest-bearing loans may be found in an examination of the legislative history of Section 501 of the Revenue Act of 1932.[16] In commenting on that provision, the House Ways and Means Committee said:

> The terms "property," "transfer," "gift," and "indirectly" are used in the broadest and most comprehensive sense; the term "property" reaching every species of right or interest protected by law and having an exchangeable value.
>
> The words "transfer . . . by gift" and "whether . . . direct or indirect" are designed to cover and comprehend all transactions (subject to certain express conditions and limitations) whereby and to the extent that *property* or a *property right* is donatively passed to or conferred upon another, regardless of the means or the device employed in its accomplishment.[17]

The United States Supreme Court pointed out that the "language of the gift tax statute, 'property . . . real or personal, tangible or in-

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[12]*An Introduction to the Philosophy of Law*, READINGS IN JURISPRUDENCE & LEGAL PHILOSOPHY 79 (Cohen & Cohen ed. 1951).

[13]Perry v. Sniderman, 408 U.S. 593, 601 (1972).

[14]Gross v. Lopez, 419 U.S. 565 (1975).

[15]*Id.* at 572.

[16]Revenue Act of 1932, § 501. This section is the forerunner of I.R.C. § 2501. The reason for more expanded discussion of "property" is to afford a better understanding of what confronted the pro-taxpayer's court in Johnson v. United States, 254 F. Supp. 73 (N.D. Tex. 1966).

[17]H. R. REP. NO. 708, 72d Cong., 1st Sess. 31 (1932). The comments of the Senate Finance Committee were identical. *See* S. REP. NO. 665, 72d Cong., 1st Sess. 39 (1932).

tangible,' is broad enough to include property, however conceptual or contingent."[18] Furthermore, it is well recognized in Anglo-American jurisprudence that the right to the use of property is one of the most valued rights inhering in ownership.[19] Money, therefore, is also considered property.[20]

C. *What is Interest?*

One of the many beneficial uses available to an owner of money is the legally enforceable right to demand and receive interest as a condition of lending it to another. Interest, however, is not considered a product of the common law, although virtually a matter of economic necessity for industrialized nations.[21] Interest has long been recognized as a "necessary incident, the natural growth of . . . money. . . ."[22]

> For tax purposes, interest has been defined by the Supreme Court of the United States as the amount one has contracted to pay for the use of borrowed money, and as the compensation paid for the use or forbearance of money. . . . The [Tax Court] has stated that interest is the compensation allowed by law or fixed by the parties for the use or forebearance. . . of money.[23]

III. GIFT TAX ANALYSIS OF INTEREST-FREE LOANS

A. *Federal District Court in Johnson v. United States*

Johnson v. United States was a case of first impression on the issue of possible gift-tax implication from the making of interest-free loans to related borrowers.[24] The essential facts reveal a taxpayer, over a period of several years, transferring substantial amounts of money to his adult son and daughter as loans that were repayable upon demand and did not bear interest. The Commissioner assessed and collected gift taxes on the theory that the taxpayer had made gifts to his children of the *use* of the money loaned. The asserted deficiency for the value of the gift was 3½ percent of the average unpaid balance as of the end of each taxable year.[25]

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[18] Smith v. Shaughnessy, 318 U.S. 174, 180 (1943).

[19] *See e.g.*, BLACKSTONE COMMENTARIES 7-8, 389 (W. Lewis ed. 1897); *see also* Spann v. Dallas, 111 Tex. 350, 235 S.W. 513 (1921).

[20] *See, e.g.*, Pirie v. Chicago Title & Trust Co., 182 U.S. 438, 443 (1901). Interestingly, the INT. REV. CODE OF 1954 does usually hold that the term "property" embraces money. *See* Rev. Rul. 69-357, 1969-1 C.B. 101; George M. Holstein, 23 T.C. 923, 924 (1955).

[21] Totten v. Totten, 294 Ill. 70, 90, 128, N.E. 295, 303 (1920). By 1900, statutes of all the states sanctioned the allowance of interest on loans. *See* Beach v. Peabody, 188 Ill. 75, 79, 58 N.E. 679, 680 (1900).

[22] Woerz v. Schumacher, 37 App. Div. 374, 376, 56 N.Y.S. 8, 11 (1899).

[23] Rev. Rul. 69-188, 1969-1 C.B. 54.

[24] 254 F. Supp. at 77.

[25] The tax years involved were 1959-1960, so Treas. Reg. § 25.2512-5 (1958) was used.

From a legal purist's point of view, the case may be seen as a gigantic wart on the face of gift tax jurisprudence. Even a law student's exam technique of tracking the statute produces skepticism. The Internal Revenue Code calls for an imposition of an excise tax[26] on the transfer[27] of property[28] by gift.[29]

It becomes readily apparent that there might be deemed a "transfer" of "property" in the case at hand. But one should also heed the implications of the court's decision. First, the court found that the children had *repaid* their demand loans.[30] This fact removes any suggestion of a mere sham transaction. Second, the "right to interest *must* arise from an express or implied contractual obligation or from statute."[31] (Emphasis added). Since there was not any recognition of interest at common law, the right to interest should not be considered an automatic right, in the absence of contract or statute to the contrary.[32]

The court further reasoned that there was no express or statutory duty on the part of the children to pay interest to their parents.[33] Nor was there an implied duty on the part of the children to pay interest since the parties specifically intended that the demand loans were non-interest bearing.[34] The court said that "[t]he time has not come when a parent must suddenly deal at arm's length with his children when they . . . start out in life."[35] "Passage of a law providing for a tax like the one here contended for should be sought through Congress instead of the courts."[36]

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[26]I.R.C. § 2501.

[27]"Transfers" which come within the meaning of the term "gift" are expressly described in I.R.C. § 2511(a). *See also* Treas. Reg. § 25.2511-1(a), (c) (1958).

[28]H. R. REP. NO. 708, *supra* note 17.

[29]"Gift" is not directly defined in the Code. However, the U.S. Supreme Court, in construing the gift tax provisions, has repeatedly emphasized that Congress was not concerned with refinements of title, but rather with the passage of control over economic benefits of property having exchangeable value and for which full value was not returned. Burnet v. Guggenheim, 288 U.S. 280 (1933). *See also* Commissioner v. Wemyss, 324 U.S. 303, 306-07 (1945), which held that the evident desire of Congress in enacting the federal gift tax was to encompass "all the protean arrangements which the wit of man can devise that are not *business transactions* within the meaning of ordinary speech. . . ." (Emphasis added).

[30]Hence, the transaction could be deemed *real* in a business sense. *See* 240 U.S. at 630-31 (1916).

[31]254 F. Supp. at 77.

[32]Interest is not part of a debt unless so stipulated in a contract. Grober v. Kohn, 88 N.J. Super. 343, 212 A.2d 384 (1965).

[33]254 F. Supp. at 77.

[34]*Id.* "There is no legal requirement, express or implied, to charge . . . [children] . . . interest on money advanced to them."

[35]*Id.*

[36]*Id.* With the Congress being vested with the almost plenary power to tax by the United States Constitution, should not a court properly refuse to legislate judicially in a nebulous area?

What might appear to be a typical cop-out goes beyond that. The court realized the many underlying issues involved. There was realization that the "parents were under no duty to lend or otherwise invest their money."[37] A person has a right to keep his cash in the proverbial mattress if he wants to. The purpose of many federal tax laws is to spur the economy by prudent investment, and even a rudimentary conception of macroeconomics tells us that "investment" is one of the important elements in developing an adequate supply curve, which helps to stabilize prices.[38] Can there be a more sound investment than that in one's own children? In a free economy, private savings and investment have an important influence on economic growth. Under private enterprise, "How fast can the economy grow?" depends greatly on how much individuals save and reinvest.[39]

The Internal Revenue Service's position may even be viewed as counterproductive, since Congress has even permitted preferential income tax rates to a person who is deemed a "Head of Household."[40] This status has been continually expanded to include any individual who provides a household for a lineal decedent, regardless of dependency, and anyone else who provides a household in which the taxpayer is entitled to a Section 151 deduction.[41] From this oversimplification, it may be concluded that Congress has directly encouraged "charity to commence at home." In the estate and gift tax area, especially, Congress has shown explicit favoritism to intrafamily gratuities.[42] In light of its reliance on the announcement by the United States Supreme Court in *Harris v. Commissioner of Internal Revenue*[43] on the purpose of the gift tax, should anyone blame the Court for its standoffish approach?

The Court there held that the enactment of gift taxes was to prevent a person from evading estate taxes through reduction of his gross estate by inter-vivos gifts.[44] Here the court in *Johnson v. United States* noted that the loans that had not been repaid were included in the decedent's gross estate.[45] The court was indirectly noting that family

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[37] *Id.*

[38] M. Lee, MACROECONOMICS: FLUCTUATIONS, GROWTH, AND STABILITY 208-307 (3rd ed. 1963).

[39] *Id.*

[40] I.R.C. § 1(b).

[41] *Id.* § 2(b) defines this term.

[42] *Id.*, For example, § 2503 (b)'s annual $3,000 per donee exclusion. Section 2503(c) even gives special treatment to transfers for the benefit of minors. Section 2513(a)(1) permits the § 2503(b) exclusion to total up to $6,000 if the proper husband and wife election is made. The Tax Reform Act of 1976 brought with it additional benefits: Section 2507 was added to give preference to bequests made to orphans, and § 2613(b)(6) permits a $250,000 exclusion for "generation skipping trusts" to grandchildren.

[43] 340 U.S. 106, 107 (1950).

[44] *Id.*

[45] 254 F. Supp. at 77.

members can deal at arm's length even though a transaction is generally presumed to be one of gift and therefore subject to "special scrutiny."[46] It has even been held that a loan to a family member is presumed to be a gift.[47] With the close analysis given to family transactions, a parent should have some freedom over the control of his property. The strongest proof possible that a loan is genuine should be the repayment of the principal.[48]

B. *The Internal Revenue Service's Position*

Surprisingly, the Internal Revenue Service did not appeal the *Johnson v. United States*[49] decision.[50] As a matter of fact, the Internal Revenue Service did not even nonacquiesce in the decision until it published Revenue Ruling 73-61.[51] In that ruling, the Service denounced the decision in *Johnson v. United States*[52] and proclaimed that they would adhere to the earlier Tax Court decision of *Gertrude H. Blackburn.*[53]

The ruling states that the right to use property—in our case, money—is described as an interest in property which results in a gift when transferred without adequate consideration.[54] Consequently, a

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[46]*See, e.g.*, Harris v. Commissioner, 340 U.S. 106 (1950); Commissioner v. Tower, 327 U.S. 280, 291 (1946); Helvering v. Clifford, 309 U.S. 331, 335 (1940).

[47]Estate of Pearl Gibbons Reynolds, 55 T. C. 172, 201 (1970). Frequently, the question arises in the context of a bad debt deduction sought by the lender. Estate of Carr, 12 T.C. 1158 (1949). The courts often conclude that a gift rather than a loan was intended. *See, e.g.*, Elizabeth N. Rude, 48 T.C. 165, 172 (1967).

[48]*See* 254 F. Supp. 73, 76. "No demand was made by taxpayers of the debtors for repayment, and the repayments . . . were voluntary rather than forced payments."

[49]254 F. Supp. 73 (N.D. Tex. 1966).

[50]2 CCH 1966 FED. EST. & GIFT TAX REP. 9006.

[51]Rev. Rul. 73-61, 1973-1 C.B. 408. *See also* Rev. Rul. 69-346, 1969-1 C.B. 227 and Rev. Rul. 69-347, 1969-1 C.B. 227. In these two earlier rulings, the Service concluded that a gift is *complete* when the donor has parted with dominion and control over the property so as to leave him no power to change its disposition, provided that the transferred interest in property is susceptible of valuation at that time. If the "donor" does not receive any interest, the amount of the gift is the full amount of the interest at the market rate applicable to that "borrower" in that location for that purpose.

[52]254 F. Supp. 73 (N.D. Tex. 1966).

[53]20 T.C. 204 (1953). There the court held that the taxpayer made a gift in the transfer of real property to her children in exchange for a note bearing interest at a rate of only 2¼ percent per annum when the market rate of interest for debt obligations secured by real estate at the time was 4 percent per annum. The court held it was proper for the Commissioner to discount the note from its lower rate of interest and to treat the amount of the discount as a gift made by the taxpayer to her children. Interesting to note, the Blackburn case had received little recognition until the Service used it as its primary source for the position taken in Rev. Rul. 73-61. The case has been cited in only three previous tax cases, none of which had anything to do with interest-free loans. *See* Estate of Inez G. Coleman, 52 T.C. 921, 926 (1969); Richard H. Turner, 49 T.C. 356, 364 (1968); and Geoffrey C. Davies, 40 T.C. 525, 531 (1963). The Commissioner failed to prevail in all three cases where the litigation was concerned with a part-gift, part-sale assertion of gift tax deficiency.

[54]Rev. Rul. 73-61, 1973-1 C.B. 408.

gift tax is imposed on the value of the right to use money, normally stated in terms of interest.[55] It held that a gift is made in each calendar quarter in which a *demand* loan is outstanding, with the amount of the gift being equal to the value of the use of the money for such portion of the year as the funds are used by the borrower before repayment.[56]

Furthermore, the ruling notes as a practical matter that a taxable gift will not arise in the case of most small interest-free loans because of the availability of the annual exclusion.[57]

The ruling fails to indicate whether the amount of the gift resulting from an interest-free demand loan is to be determined by reference to the market rate of interest prevailing at the time of the loan or by application of the tables in the regulations.[58] In the case of a demand loan, the ruling merely states, "The rate of interest that would represent full and adequate consideration may vary, depending upon the actual circumstances pertaining to the transaction."[59]

If, instead of employing the rates of interest as set out in the regulations, the gift is valued according to market rates of interest on arm's-length loans, there will be substantial uncertainty about the

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[55] *Id.*

[56] *Id.* A parent borrowed $200,000 from a bank and later in the same month loaned $250,000 to his son's wholly-owned corporation, receiving in return two non-interest bearing notes. The first note was in the amount of $50,000, payable at the end of ten years; the second was a demand note in the amount of $200,000. In the case of the term loan, it was held that a gift equal to the value to the right to use the money for the term of the loan had been made at the time the loan was granted.

[57] *Id.* The ruling, however, fails to discuss the requirement of a "present interest" contained in I.R.C. § 2503(b). Treas. Reg. § 25.2503-3(a) holds that a future interest is one "limited to commence in use, possession or enjoyment at some future date of time." Furthermore, subpart (b) of the same regulation says that "[a]n unrestricted right to the immediate use, possession or enjoyment of property or the income from property is a present interest in the property." If the privilege of using someone else's money is deemed property and subject to gift taxation, then an interest-free demand note should surely qualify as a "present interest."

[58] Although the method of determining the appropriate interest rate is not free from doubt, it appears that the same rate should be employed for a demand loan's interest and a term obligation's discount. *See* Rev. Rul. 73-61. In the case of a term loan, the ruling states that the value of the "right to the use of the money loaned is ascertainable by accepted actuarial methods, as of the date the money and the note were exchanged, and is, therefore, subject to the gift tax at that time. *See* Section 25.2512-5 of the regulations." The ruling made reference to Treas. Reg. § 25.2512-5 in ascertaining the value of the right to use money loaned, which creates additional confusion since that section contains the rate of 3½ percent per annum for valuation of an interest transferred on or before December 31, 1970. It is unclear why the ruling refers to the old rates instead of Treas. Reg. § 25.2512-9, which contains the tables using a 6 percent per annum rate for valuing transfers made after December 31, 1970. The reason may have been that the loan involved was made prior to 1971.

[59] Rev. Rul. 73-61, 1973-1 C.B. 408, 409. The Treasury announced a standard that ranks second in nebulousness only to the reasonable prudent person standard of negligence.

amount of the gift. If judged by arm's-length standards, an unsecured demand or term loan from lender to a related borrower might require the use of a very substantial rate of interest. A standard unsecured loan might require an interest rate in excess of eighteen percent.[60] Does a state usury law also come into play as a limit to the maximum amount of interest to be imputed as a gift?

What about the income actually produced from the investment of the interest-free loan? Should it be used as a gauge for valuation of the imputed interest that is sought to be taxed as a gift? If the value of the economic benefit received by the donee is emphasized, rather than the value of what is transferred at the time of making the loan, a number of fundamental principles of federal gift taxation will be violated. For example, the regulations provide "[t]he gift tax is not imposed upon the receipt of property by the donee, nor is it necessarily determined by the measure of enrichment resulting in the donee from the transfer. . . . On the contrary, the tax . . . is an excise tax upon [the] act of making the transfer . . . measured by the value of the property passing from the donor. . . ."[61] The heralded case of *Guggenhiem v. Burnet*[62] also held that one must look to what the donor relinquishes, rather than to what is received by the donee. This approach would also have the disadvantage of leaving the transaction open as in *Burnet v. Logan*.[63] Besides being "open," an additional problem with this suggestion is that it will add the burden of tracing the amount of income arising from the loan proceeds. Also, the converse situation, where the borrower was unsuccessful in being a Wall Street wizard, should dictate no gift because of no income produced.

Finally, the employment of a flat rate of interest, as the ruling suggests, also has its drawbacks. Even though this method is consistent with the method of valuation of other interests requiring a rate of return assumption,[64] a degree of tax avoidance still can be achieved as long as the interest rate for market investments remains in excess of six percent per annum.[65]

C. *The Tax Court in Crown v. Commissioner*

The Tax Court's position on the issue of interest-free demand loans was made clear in *Crown v. Commissioner*,[66] a 1977 decision. The taxpayer was a member of a partnership that had made non-interest-bearing demand loans to trusts for the benefit of members of the part-

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[60]A standard revolving charge account, such as Visa or Mastercharge, afixes this amount to the unpaid balance.

[61]Treas. Reg. § 25.2511-2(a) (1966).

[62]288 U.S. 280 (1933).

[63]283 U.S. 404 (1931).

[64]*See* Treas. Reg. § 25.2512-9 (1966).

[65]*Id.*

[66]67 T.C. 1060 (1977).

ners' families.[67] The Commissioner, adhering to Revenue Ruling 73-61's precepts,[68] determined that each of the interest-free loans made by the partnership to the various trusts resulted in a gift equal to the value of the use of the money.[69] An average prime rate of 5.63 percent per annum was used to determine the amount of the gift.[70]

The Tax Court disagreed with the Commissioner and elected to follow *Johnson v. United States*,[71] holding that there was no gift. The court reflected on the primary concern of the Commissioner that the ultimate estate would be diminished by anticipated amounts the lender *might have* earned with the loaned funds if properly invested.[72] The court stated in response:

> [O]ur income tax system does not recognize unrealized earnings or accumulations of wealth and no taxpayer is under any obligation to continuously invest his money for profit. The opportunity cost of either letting one's money remain idle or suffering a loss from an unwise investment is not taxable merely because a profit *could have been made* from a wise investment.[73]

Continuing, the Tax Court said that "[t]he courts have uniformly rejected every attempt by the Internal Revenue Service to subject the making of non-interest-bearing loans to income or gift taxes. . . . If the making of non-interest-bearing loans is to become a taxable event, we think Congress, not the judiciary, should clearly say so."[74] The court further recognized the danger in opening Pandora's Box by stating that if the Commissioner's principle was established, there could be a "multitude of situations involving gratuitous use or sharing of real or personal property among relatives"[75] that could fall within. The mere use of dear old dad's home while he is in Europe for six months may result in a gift tax if dad *might have realized* ten thousand dollars by renting to complete strangers.

There are many reasons not to tax an interest-free demand loan to a related borrower as a gift. As the court pointed out, there is no im-

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[67] *Id.* at 1061. The amount in controversy was a very *substantial* $2,073,649 on the demand notes and $15,956,375 on open account. The total imputed interest amounted to a sum of $1,086,407.75.

[68] *Id.* The trusts were not required to pay any interest until the lender demanded repayment. *See* Rev. Rul. 73-61, 1973-1 C.B. 408.

[69] 67 T.C. at 1062.

[70] *Id.* at 1061. This apparently is the method the Commissioner will use to calculate the gift arising from interest-free demand loans.

[71] 254 F. Supp. 73 (N.D. Tex. 1966).

[72] 67 T.C. at 1063.

[73] *Id.* at 1063-64.

[74] *Id.* at 1064.

[75] *Id.* at 1065. The Tax Court noted that the "application of the gift tax to common intra-family sharing of use of property seems administratively unmanageable, and such situations point up the difficulty with the concept of gift taxation attaching to more permissive use." *Id.*

plied duty to reinvest money saved in a productive manner.[76] A person is privileged to hoard his excess capital behind the mantle of the fireplace, or he may foolishly gamble it away in a French casino on the Riviera. In either instance, the federal government has not benefitted by an increase in the gross estate. That a lender would get more satisfaction from making an interest-free demand loan to a child than he would from squandering his excess money on consumable assets, luxury items without a resale market, or junket trips to the world's gambling halls should be no reason to slap an excise tax on him. A lender still has all of the inherent risks that are involved in any type of investment. He does not escape the possibility of losing all by imprudent investments on the part of the related borrower. His only reward is seeing a relative make it in the business world. Besides, if the Commissioner has his way, why should not a guarantor for a loan to a relative be treated as making a gift, at least to the extent of difference in the interest rate charged with the guarantor's security and the interest rate that would be charged by the local neighborhood's loan shark, who has never heard of usury laws?

Perhaps these were some of the extremes that the Tax Court had in mind when they concluded the opinion with Justice Holmes' axiom: "[A] page of history is worth a volume of logic."[77]

IV. Income-Tax Analysis of Interest-Free Loans

A. *Previous and Present Law*

Revenue Ruling 73-61[78] is concerned solely with the gift tax aspects of interest-free loans between family members as were the courts in *Johnson v. United States*[79] and *Crown v. Commissioner*.[80] However, it is possible that the Commissioner could try to impute interest for income tax purposes under Section 482.[81] Section 482 of the Internal Revenue Code authorizes the Commissioner to distribute, apportion, or allocate gross income, deductions, credits or allowances among two or more commonly owned or controlled entities if he determines such action is necessary to prevent evasion of taxes or to reflect income clearly.[82]

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[76] *Id.* at 1063-64.

[77] *Id.* at 1065 (quoting New York Trust Co. v. Eisner, 256 U.S. 345, 349 (1921)). The Tax Court also noted the Service's failure to contest such transactions in the past.

[78] 1973-1 C.B. 408.

[79] 254 F. Supp. 73 (N.D. Tex. 1966).

[80] 67 T.C. 1060 (1977).

[81] I.R.C. § 482.

[82] *Id.* Reference may perhaps be made to Section 483, which was added to the income tax provisions of the Code by the Revenue Act of 1964. That section attributes interest to payments made under certain contracts for the sale or exchange of propery when payment is deferred and interest is either unstated or fixed at an unreasonably low rate. The problem with Section 483 analysis is that the section was designed to prevent a specific evil—conversion of interest income into capital gains. *See* I.R.C. § 483(f)(3).

A quick glance at the requirements of Section 482 shows that the particular section was specifically intended for imputation of interest among related entities and *not* related individuals. The three requirements of Section 482 must be met:

(1) Two or more organizations, trades or businesses,

(2) Ownership or control directly or indirectly by the same interests, and

(3) A finding by the Commissioner that it is necessary to allocate gross income, deductions, credits, or allowances to prevent evasion of taxes or to clearly reflect income.[83]

For instance, do the above requirements apply to an intra-family partnership that makes interest-free loans to trusts for the benefit of other members of the family?[84] Section 482 of the Internal Revenue Code may fail to apply because of the "control" requirement necessary to constitute "ownership" of the two entities by the lender.[85] The case law involving imputation of interest among related entities through Section 482 has not been altogether consistent.[86]

The most prominent decision against the imputation of interest to a lender of an interest-free demand note is the case of *J. Simpson Dean*.[87] The taxpayers, husband and wife, received substantial loans of money from their controlled corporation in exchange for interest-free notes. The Commissioner unsuccessfully contended that the taxpayers realized income to the extent of the economic benefit derived from the use of the money that was borrowed without interest.[88] The Tax Court's decision rested on the recognition that if the taxpayers

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[83]I.R.C. § 482. The problem encountered with Section 482 is that the courts have considered its application to the area of interest-free loans among related individuals and have rejected it. *See, e.g.*, Saunders v. United States, 294 F. Supp. 1276, 1282 (D. Hawaii 1968) (taxpayer held not to receive compensation when he was issued non-interest-bearing loans) *rev'd.* on another issue, 450 F.2d 1047 (9th Cir. 1971). *See also* Joseph Lupowitz Sons, Inc. v. Commissioner, 497 F.2d 862 (3rd Cir. 1974), which relied in part on the Tax Court's reasoning in J. Simpson Dean, note 87 *infra*.

[84]Essentially the same fact situation was involved in Crown v. Commissioner, which was litigated solely on the issue of gift taxation.

[85]*See* Hewitt, *Section 482—Allocation of Income and Deductions Among Related Taxpayers*, N.Y.U. 20TH ANN. INST. ON FED. TAX 463 (1962); Schlitke, *Taxing as Income the Receipt of Interest—Free Loans*, 33 U. CHI. L.R. 346 (1966).

[86]*The cases concerning allocation of interest have reached three separate and* distinct results. The early cases deny the imputation of interest where the parties intended that no interest be charged, and interest was neither accrued by the lender nor deducted by the borrower. Combs Lumber Co., 41 B.T.A. 339 (1940). The second approach, which is the current position of the Tax Court, is that interest can be allocated only where the borrowed funds generate income to the lender. Society Brand Clothes, Inc., 18 T.C. 304 (1952). Finally, the position of the Second Circuit is that interest should be imputed in accordance with the Section 482 Regulations. B. Forman Co., Inc. v. Commissioner, 453 F.2d 1144, *cert. denied* 407 U.S. 934 (1972).

[87]35 T.C. 1083 (1961).

[88]*Id.*

had interest imputed to them, they would be entitled to a corresponding Section 163 deduction, which would constitute a "wash."[89] Even though this case has been heralded as a "Monday morning once-in-a-lifetime happening,"[90] the Tax Court, in its majority and dissenting opinions in *Crown v. Commissioner*,[91] still acknowledges the precedent set therein. Surprisingly, the government did not appeal *Dean*, and it waited twelve years to announce officially its nonacquiescence.[92] Although *Dean* was concerned with a corporation making interest-free loans to shareholders, the case is cited to illustrate the utter confusion in the area.[93]

The Internal Revenue Service has not exactly been consistent in its treatment of interest-free loans in the income tax area. Interest-free loans and their effect on the gross income of both lenders and borrowers have been the subjects of many tax rulings, often resulting in different interpretations. For example, in a recent technical advice memorandum, the Internal Revenue Service ruled that a lender who makes an interest-free loan to an *unrelated party* does not recognize any gross income.[94] In ruling that no gross income is imputed to the lender of an interest-free loan, the Commissioner followed the rule of established case law.[95] However, this ruling once again accentuates the fact that lenders and borrowers of interest-free loans receive different treatment from the Internal Revenue Service. With the nonacquiescence in *J. Simpson Dean*,[96] the Commissioner formally announced that gross income will be imputed to the borrower of an interest-free loan.[97]

The recent technical advice memorandum[98] gave no justification for the different treatment accorded lenders and borrowers, which adds further confusion to utter chaos. It has long been the Commis-

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[89]I.R.C. § 163. *See* J. Simpson Dean, 35 T.C. 1083, 1091-92 (1961) (Bruce, J., dissenting), which correctly concludes that a Section 163 deduction is not automatic, because of Section 265(2)'s prohibition on using the loan proceeds to purchase or carry tax-exempt bonds.

[90]Lecture given by Professor Breeland to a L.L.M. class at the University of Florida (winter quarter, 1977).

[91]67 T.C. 1060 (1977).

[92]1973-2 C.B. 4.

[93]*See* O'Hare, *The Taxation of Interest-Free Loans*, 27 VAND. LAW REV. 1085, 1095 (1974).

[94][1977] INT. REV. SERV. Letter Ruling (CCH) 7731007.

[95]Brandtjen & Kluge, Inc., 34 T.C. 416 (1960); Society Brand Clothes, Inc., 18 T.C. 304 (1952); Combs Lumber Co., 41 B.T.A. 339 (1940). Moreover, a conflict with the *Dean* rationale is found in a number of cases holding that a borrower has no interest deduction on an interest-free loan. Loveman & Son Export Corp., 34 T.C. 776 (1960); Howell Turpentine Co., 6 T.C. 364 (1946); Rainbow Gasoline Corp., 31 B.T.A. 1050 (1935).

[96]35 T.C. 1083 (1961).

[97]1973-2 C.B. 4.

[98]Note 94, *supra*.

sioner's position that gross income is imputed to the *borrower* of an interest-free loan. Presumably, the Commissioner will continue to assert that interest-free loans to employees or stockholders are analagous to the rent-free use of corporate property. However, the Commissioner, in ruling no income is imputed to the lender, reasoned that the right to receive income never came into existence because the parties never intended to create a liability. Furthermore, when the borrower is an unrelated party instead of an employee or stockholder, the interest income that would be imputed under the Commissioner's position would most likely in any event be deductible under Section 163.[99] This assumes, of course, the interest deduction is not barred by an exception such as Section 265(2)'s prohibition on using the loan proceeds to purchase tax-exempt bonds.[100]

The present law and the Internal Revenue Service's position thereon raise many questions about the different treatment accorded lenders, related borrowers, and unrelated borrowers of interest-free loans. Perhaps the Internal Revenue Service should revert to simple basics, such as Section 61(a) of the Internal Revenue Code of 1954,[101] which is the primary vehicle for taxing economic benefits. Between unrelated individuals in an arm's-length transaction, it is readily apparent that the borrower could be deemed to have recognized income from an interest-free loan. The income tax analysis of a gift would not apply since the prerequisite "detached and disinterested generosity" is not usually present.[102] However, as to interest-free loans between family members, the question arises whether there was an arm's-length transaction. For gift tax purposes, the showing that the loan is repaid or that it is secured may help to negate the implication of a true gift; on the other hand, income tax may be assessed on the borrower to the extent of economic benefit derived.[103]

Crown's majority may have found the key in saying that "there are policy considerations which militate against viewing the value use of money or property as a *taxable event*. . . ."[104] (Emphasis added). A recent example of what the court may have had in mind appeared in

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[99]I.R.C. § 163.

[100]*See* note 89, *supra*.

[101]"Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, ..." I.R.C. § 61(a). Treas. Reg. § 1.61-1(a) (1954) asserts that gross income includes "income realized in any form, whether in money, property, or services." The courts have recognized that Congress intended a very broad interpretation of "gross income." *See* Commissioner v. LoBue, 351 U.S. 243, 246 (1956). *See also* Dean v. Commissioner, 187 F.2d 1019 (3rd Cir. 1951) (rent-free use of a corporation's house); Bardahl Mfg. Corp., 19 T.C.M. (CCH) 1245, 1252 (1960) (personal use of a corporation's automobile).

[102]I.R.C. § 102(a).

[103]I.R.C. § 102(b).

[104]67 T.C. 1060, 1065 (1977).

the *Wall Street Journal*, under the title "Is $20 Billion Hidden from the Tax Collector?:"

> Using its data on compliance, the IRS estimated that a total $1.8 billion in dividends and interest wasn't reported in 1973 (Commerce Department's estimate for the same period was closer to $20 billion). Whichever estimate is closer to the true amount, a lot of money may be involved. But the Treasury doesn't want to beef up enforcement. It fears that could "generate taxpayer resentment so great as to . . . jeopardize the very foundation of the entire system of voluntary compliance," a Treasury official recently warned Congress. . . .[105]

B. *Assignment of Income Doctrine*

While the income produced by borrowed funds is normally taxed to the borrower, it is *arguable* that the income arising from an interest-free loan should be taxed to the lender through the application of the assignment of income doctrine.[106]

The doctrine may be illustrated by analogy to a tree and its fruit:

> The owner of the tree picks some fruit and gives it to another who converts it to cash. As the owner has kept the tree that produces the fruit, the tree's produce . . . remains his for tax purposes, even though economically it has become the property of another. . . .
>
> If the owner gives away the tree . . ., the donee in general is taxable on fruit subsequently produced . . ., because he has become the owner of the income-producing property itself. . . . In many instances, however, it is difficult to say what should be regarded as fruit. Mere appreciation in the value of property (the tree) is not fruit until it is realized. . . .[107]

But, unlike the classical *Horst v. Helvering*[108] decision, the same income tax problem is not confronted. With an interest-free loan, the income interest has not yet *matured* when the initial transaction occurs.

For example, if a father made an interest-free loan to his son of $100,000 which was outstanding for a year, and if we assume a simple interest rate of 6 per cent per annum, the father, at first glance, appears to be escaping income taxes on $6,000 by the fruit-tree analogy. However, if the father had charged a reasonable interest rate to the son for the use of his money, he would have realized gross income of that amount while the son would have gotten a corresponding deduction.[109] There are many difficulties with the application of the doc-

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[105]Jacobs, *Tax Report*, Wall St. J., Mar. 22, 1978, at 1, Col. 5. (March 22, 1978).

[106]FREELAND, LIND, & STEPHENS, FUNDAMENTALS OF FEDERAL INCOME TAXATION, 265 (2d ed. 1977).

[107]*Id.* at 288.

[108]311 U.S. 112 (1940).

[109]I.R.C. §§ 61(a), 163 (assuming § 265 is not applicable).

trine. Should the market rate for interest be imputed to the father, or should the actual income earned off the principal loaned be considered the fruit?[110]

The greatest difficulty appears because of the differences in a gift for gift tax purposes and one for income tax purposes.[111] Failure to tax the lender on income produced by an interest-free loan might result in that income's escaping taxation altogether. If the income produced by the loan is treated as a gift, the borrower may contend that it is therefore excludable from his own income. Unless the income is then taxed to the lender on assignment of income principles, it may not be subjected to income taxation at all.

Now it is easy to realize the predicament that the Internal Revenue Service is in. The income-shifting potential of interest-free loans has not been attacked by the Internal Revenue Service, and it is doubtful that there is existing doctrine sufficient to meet the threat.[112] Perhaps there is not so great a threat of attack by the Internal Revenue Service, since a person is still under no duty to reinvest his savings if he chooses to forego the opportunity to increase his net worth. A lender can always escape income taxation by investing the principal in tax-free bonds, as provided by Section 103.[113] A lender would then enjoy tax-free dollars to spend without the apparent risk or hassle involved in making an interest-free loan, especially if it is to a relative.

C. *Short-Term and Grantor Trust's Implications*

The issue of income taxation of interest-free loans may be more readily understood by reference to Code provisions charging the grantor with income of short term and revocable trusts.[114] These provisions are designed to prevent the use of the trust device to transfer the income potential of a grantor's capital except where the grantor also passes an interest in the corpus sufficient to justify separate income treatment to the beneficiary. The principle of making interest-free loans—especially if they are demand notes—suggests that a taxpayer can successfully split income with members of his family by surrendering only the immediate possession of his money.

The problem is that interest-free loans, payable on demand or in the form of short-term notes, are not embraced by the grantor trust

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[110] What if the son invested in tax-exempt bonds?

[111] Commissioner v. Duberstein, 363 U.S. 278 (1960), held that the question whether a transfer of money or property constitutes a gift within the exclusion of Section 102(a) of the Code is an issue of fact on whether there was the prerequisite donative intent. A gift for Section 2501's excise tax, on the other hand, is based on property passing for less than adequate consideration in dollars or dollars worth. *See* I.R.C. § 2512(b).

[112] See discussion of §§ 482,483 at note 81, *supra*. 25 J. Tax. 358 (1966) recognizes the issue and suggests that it belongs to the field of imputed income.

[113] I.R.C. § 103.

[114] I.R.C. §§ 673(a), 676(a).

provisions of the Code: "Part 1 [of Subchapter J] has no application to any organization which is not to be classified for tax purposes as a trust under the classification rules of Section 301.7701-2, 301.7701-3, and 301.7701-4. . . ."[115]

> Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.[116]

There is case law that seems to be a little more on point in this area than the regulations. In *Corliss v. Bowers*,[117] the United States Supreme Court upheld the power of Congress to treat the grantor of a revocable trust as the owner of the corpus and to tax him on the income of the trust. Merely on the basis of general income tax principles, the High Court, in *Helvering v. Clifford*,[118] held that a grantor who had created a trust for a five-year term for the benefit of his wife was taxable on the income: because of the retained power, he was still the substantial owner. These cases and others seem to be consistent with taxing the lender on the income produced from the principal of an interest-free loan. However, once again the theory runs aground on the fact that the lender has the right not to invest his property if he sees fit. There seems to be a slender line separating the fruit-tree doctrine and grantor trusts on the one hand and interest-free loans on the other.

There seems to be an even clearer line where a lender lends to a borrower—especially a trust or relative—an interest-free loan, but retains a security interest in the property purchased with the loan. Even going one step further, a security agreement might be found where the loan of the interest-free dollars is conditioned on a particular use of the funds, such as investment in certain low-risk securities. An interest-free loan that might escape income taxation to the lender would seem to have all of the benefits and none of the drawbacks of a short-term trust under the Internal Revenue Code. The lender can retain essentially the same interest—or perhaps even a greater interest—in the funds as the grantor of a short-term trust who has a reversionary interest which will take effect in less than ten years. The grantor will continue to be subject to income tax on the trust income,[119] however, while the lender will escape income taxation. The possibilities will be readily perceived by the tax planner.

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[115]Treas. Reg. § 1.641(a)-0(a) (1954).

[116]Treas. Reg. § 301.7701-4(a) (1954). By this definition, Section 482 or a similarly enacted statute may be the way to impute interest.

[117]281 U.S. 376 (1930).

[118]309 U.S. 331 (1940).

[119]I.R.C. § 673(a).

V. The Downside Risk Involved in Utilizing Interest-Free Loans

A. *In General*

In our society, where capital is a money-making tool, an essential resource, and an absolute necessity in order for an entrepreneur's vision to materialize into reality, the individual still has the final say on the type of risk he is willing to accept for investment of his excess capital. Even though he can invest his savings of $500,000 safely at six percent interest and earn $30,000 of income per year through a savings account, he may permit the principal to sit idly in a non-interest-paying checking account or other nonproductive investment without having income imputed to him. But if he lends the $500,000 to his child without charging interest, and the child turns around and puts the principal in a savings bank to earn $30,000 per year, he might be said to have made a gift of that amount, which will be subject to a gift tax. He may also find that the income assigned or imputed to him for income tax purposes.[120]

In order to calculate the risk involved if the tax planning goes astray and the Commissioner has his way, we will assume that T, typical taxpayer, has $500,000 of excess funds lying about. The prime rate for interest is six percent per annum for the period of the hypothetical.[121]

B. *Gift Taxation of an Interest-Free Demand Loan*

Without exceeding the scope of the article, that is, interest-free *demand* loans, it is worthwhile to note the distinction between interest-free demand and term loans and the tax consequences of each. In the case of a term loan, the promise to repay becomes enforceable only at some time in the future. In contrast, the promise to repay a *demand* loan is presently enforceable by the lender. The present value of the reversionary interest in the loan proceeds that the lender retains by way of the borrower's promise to repay, in the case of an interest-free *term* loan, is worth less than the amount of the loan. The difference in present value and future interest is determined by an appropriate discount factor, which is presumably the same as the rate of interest that

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[120]Since this is a downside risk problem, we must assume both will happen to the donor. With the donee or borrower, he should be able to escape income taxation either by the § 102(a) gift exclusion or a wash via a § 162 interest deduction. The latter and ZBA implications will be discussed *infra*.

[121]For purposes of the worst-case analysis, an average prime rate of six percent will be used. Keep in mind, however, the method of valuation for interest-free loans is as uncertain as the taxability itself. *See* discussion at note 58, *supra*. Another problem with valuation can be perceived, which may further complicate matters: what happens when the so-called prime rate is a mere six percent at the time of the transaction but jumps up to, say, eight percent at the end of the year? For this reason, we are assuming an average prime rate to avoid additional computational knuckle drill.

would be imputed on an interest-free demand loan under our assumption.

For example, if T makes a loan of $500,000 to his son, repayable at the end of ten years, the present value of the son's promise to repay, discounted at six percent, is $270,197.50.[122] At the time the loan is made, the value of the loan proceeds transferred from T to his son exceeds the value of the son's promise to repay by $220,802.50. Since a man who deals at arm's length with another is not expected to forego such an amount in a real business context, a gift is deemed to have been made at the time of the initial transfer.

On the other hand, a demand loan has the advantage of being presently repayable immediately upon request of the lender. Therefore, the *present value* of the obligation to repay is deemed to be equal to the value of the money lent. One may go one step further with this line of thought and assert that since the promise to repay *and* the present value of what was transferred, i.e., principal of the loan, are *equal*, then no gift in reality has occurred.

An illustration that differentiates the treatment of the loans shows the economic infeasibility of using an interest-free term, versus demand, obligation. Recall that the Commissioner would assert that a gift of $220,802.50 was made on the initial transfer of an interest-free *term* loan of $500,000 for ten years.[123] On the same $500,000, Revenue Ruling 73-61[124] and the Commissioner's position in *Crown*[125] would hold that there has been a gift only of the imputed interest for each calendar quarter the loan proceeds are outstanding. Using six percent per annum for uniformity, there would be deemed to have been a $30,000 gift for each year the loan is outstanding. That means a difference in tax treatment in the initial year of almost $200,000. In addition, Revenue Ruling 73-61[126] points to the fact that most interest-free demand loans will escape the gift tax altogether because of the Section 2503(b)[127] annual $3,000 exclusion which would be applicable. That means the demand note would afford a tax savings of an additional $30,000 over ten years, while the term loan would be entitled to only $3,000 exclusion in the year of the transfer. The bottom line is that the term loan would generate a total taxable gift of $217,802.50, while the demand note would generate a taxable gift of

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[122]*See* Treas. Reg. § 25.2512-9 (1966).

[123]*See* note 56, *supra*. The Commissioner utilized this method in regard to a term loan which was made interest-free.

[124]1973-1 C.B. 408.

[125]*See* note 70, *supra*. The Commissioner ascertained that the interest rate to be imputed was the average prime rate of 5.63 percent per annum. The actual method of computation used to arrive at this figure was not alluded to in the court's opinion.

[126]1973-1 C.B. 408.

[127]I.R.C. § 2503(b). The hypothetical will assume that the § 2513 election, which can raise the annual exclusion to $6,000, is not utilized.

$27,000. There is a difference in total tax due over the period of ten years, but the present value of cash-in-hand should make up the difference. It will not be difficult for the tax planner to see the preferable route if the Commissioner's position is taken.

Perhaps this explains the mystique of the interest-free demand loan vis-a-vis the term obligation. If the two types of interest-free loans are differentiated in this way, a lender would be foolish to make a term obligation interest free. Besides having to muster the entire amount of gift tax liability on the initial transfer for an interest-free term loan, the lender loses the flexibility and control of the asset itself for the term proceeds are outstanding.

The bottom line is that this still may be a relatively inexpensive way to, in effect, give a child an income interest which will be similar to a trust, without the legal hassle and payment of trust management fees. Especially will this be true if the demand loan is secured by assets capable of appreciation, such as stocks. The lender's taxable gift will be fixed (subject to changes in the interest rate on which the computation is based), while the borrower will enjoy any appreciation in the value of the investments made with the loan proceeds.

C. *Income Taxation of an Interest-free Demand Obligation*

The income taxation of interest-free demand loans between related individuals may be baffling, to say the least. There are possible income tax implications to either the borrower or the lender in such situations.

First of all, the borrower, since he is related to the lender, should not be considered to have received compensation for services by the use of an interest-free loan. The imputed interest that he should have paid should be considered a gift via Section 102(a). If the actual income produced by an interest-free loan is considered a gift, the borrower may raise this contention against the imposition of an income tax.

However, since we are considering worst-possible-nightmare analysis, we must assume that the borrower, child of the lender, will be taxed on the market value of the use of the funds. The Commissioner can make an argument that there is no detached and disinterested generosity involved since there is a mere loan versus outright gift of the proceeds, especially if the note is secured by a complex loan arrangement. The big problem here, making this the worse possible situation, is that double taxation can result. The borrower will pay one tax on the potential income represented by the market value for use of the funds, and he will be taxed additionally on the income actually produced.

To illustrate, using our hypothetical, the borrower would have imputed to him an income of $30,000 per annum, the value (at six percent) of the money lent; he will also be taxed on the amount of income produced, which should equal or exceed the going interest rate if the money is merely placed in a savings account. The borrower could thus be taxed to the tune of a conservative $60,000 per annum. The lender may be liable for income tax upon the making of an interest-free loan. He would have imputed income from forbearance of the interest that he could have made by a comparable arm's-length transaction. For purposes of this analysis, we will still assume six percent, but a planner should realize that the market value could be found to be much greater for a poor credit risk.[128] In fact, if market value is the standard applied, the only limit upon the amount of interest which may be imputed would be a state's usury law, which may have no bearing on this federal question. The lender, if a six percent rate is applied, would recognize gross income of $30,000 per year from the interest-free loan.

Since the use of a flat rate may still effect a reduction of gross income if the loan proceeds produce a return greater than six percent, the Commissioner would, by the worst-case theory, assert there has been an assignment of income: that is, that the income to be imputed to the lender is equal to the economic benefit derived by the borrower from the free use of the money, as measured by what was actually gained by its use. Under this analysis, rather than making an interest-free loan, the lender would be viewed as purchasing assets for the use or benefit of the borrower. The fruit is given to the borrower but the tree is retained.[129] Hence, the lender would be taxed to the extent of the income produced, but the borrower would be deemed to have received a gift of the fruit.

The income tax ramifications are complex to say the least, especially when taxation in one direction merely opens a loophole in the other.

VI. CONCLUSION

There are conflicts in the taxation of interest-free loans. Demand loans have been successful in escaping gift taxation. The mere fact that they are non-interest bearing appears not to be a factor calling for realization of gross income.

The biggest problem confronted in both areas is the Internal Revenue Service's worry that a person is not investing his savings appropriately in order to realize more income, and thereby increase his gross estate. Until Congress makes it a duty to invest—a doubtful eventuality—the area of interest-free loans may remain quite muddled. Perhaps it would be better for the Service and Congress to take a deep, thorough look at what is truly involved. The taxation of interest-free loans may lead to the possible imputation of income from

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[128] *See* text, note 57-59.
[129] *See* text, note 105-107.

many sources, such as the use of one's own home, services rendered by a housewife, services performed by the taxpayer for his own benefit, etc.

Of course, as far as the gift-tax area is concerned, the taxpayer is not decreasing his gross estate by making a non-profit transaction with one of his relatives. If he dies, the same amount loaned will still be included in the estate's taxable base. Likewise, in the income-tax area, the amount of income earned on the principal of the loan will still be taxed as gross income if the investment was not in tax-exempt bonds; it is just a matter of who the taxpayer will be—borrower or lender. It is possible that the whole matter of interest-free loans falls into that category of things which a government must tolerate in a free enterprise system such as ours.

Only the future will answer most of the questions raised in this article. Congress may ultimately set the height of the pole for this particular limbo contest. For now, however, the taxpayer must look to the court system for the rules on how low he can go.